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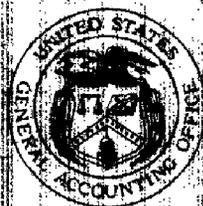
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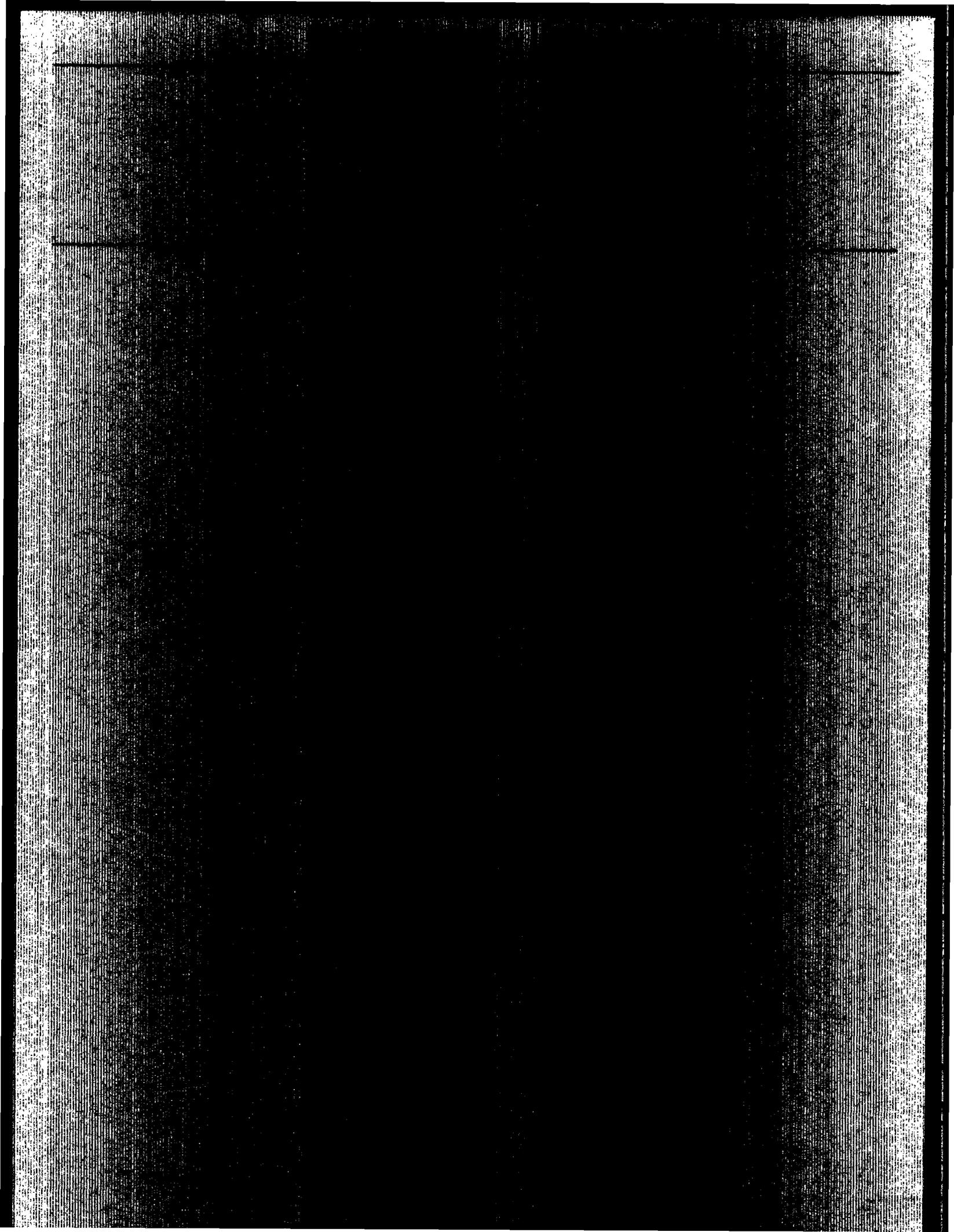
Report to the Chairman, Subcommittee
on Oversight of Government
Management, Committee on
Governmental Affairs, U.S. Senate

February 1994

**DEFENSE
INVENTORY**

**Changes in DOD's
Inventory Reporting,
1989-1992**







United States
General Accounting Office
Washington, D.C. 20548

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National Security and
International Affairs Division

B-256304

February 10, 1994

The Honorable Carl Levin
Chairman, Subcommittee on Oversight
of Government Management
Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

This report responds to your request that we analyze changes in the Department of Defense's (DOD) secondary item inventory since fiscal year 1989. You specifically asked that we provide information on (1) the total value of this inventory, (2) the value of potential reutilization/disposal (excess) stock, (3) the impact of revaluations on the inventory, and (4) annual funding levels for buying secondary item inventory. This report includes inventory data for fiscal years 1989 to 1992 and inventory budget figures for fiscal years 1992 to 1994. We will provide fiscal year 1993 inventory data, fiscal year 1994 appropriations amounts, and DOD's fiscal year 1995 budget estimates when they become available.¹

Background

DOD maintains stocks of spare and repair parts, clothing, medical supplies, and other support items that are referred to as secondary inventory items. DOD reports the amount of its secondary item inventory annually in its Supply System Inventory Report. In the report, DOD also identifies the amount of inventory that has the potential for reuse by other DOD components or government agencies or that may be disposed of through sale to the public. This category of inventory is known as potential reutilization/disposal stock. Before fiscal year 1991, DOD referred to it as potential DOD excess inventory.

The Supply System Inventory Report shows the value of inventory as of the end of each fiscal year. In this sense, it provides a "snapshot" of on-hand inventory levels. The report does not show inventory changes such as purchases, issues, and disposals. While our prior work has shown accuracy problems in the systems providing data for this report, it is the best data available on DOD-reported inventory values.

¹According to DOD officials, fiscal year 1993 inventory data and fiscal year 1995 budget estimates will be available in March 1994. Adjusted fiscal year 1994 appropriation amounts will also be available in March 1994.

Results in Brief

DOD's Supply System Inventory Reports show that the nominal value of the secondary item inventory decreased \$29.2 billion between fiscal years 1989 and 1992, from \$109.4 billion to \$80.2 billion. However, the inventory values reported by DOD are not comparable. This is due to accounting changes that have taken place since 1989. Adjusting DOD's secondary inventory for the changes and valuing it all at the latest acquisition cost, we estimate that the total inventory decreased by \$7.6 billion between fiscal years 1989 and 1992. Also using the acquisition value, we estimate that inventory DOD places in the potential reutilization/disposal category increased by \$7 billion.

If the latest acquisition value of DOD's inventory is revalued to reflect needed repair costs and scrap values of potential reutilization/disposal stock, inventory values decreased by \$12.3 billion between fiscal years 1989 and 1992 and potential reutilization/disposal stocks increased by less than \$200 million.

Congress approved Defense Business Operations Fund (DBOF)² customer funding levels of \$26.7 billion in fiscal year 1992 and \$26 billion in fiscal year 1993 for secondary inventory items. The amounts appropriated were effectively reduced to \$25.2 billion and \$20 billion, respectively, as a result of congressionally directed fund transfers from DBOF and other accounts. In its fiscal year 1994 budget, DOD requested \$26.2 billion for secondary inventory items.

Reported Inventory Values Are Not Comparable

DOD's Supply System Inventory Reports show that the nominal value of the secondary item inventory decreased \$29.2 billion between fiscal years 1989 and 1992, from \$109.4 billion to \$80.2 billion. The reports also show that during this period the value of the potential reutilization/disposal stock decreased by \$9.8 billion. (See table 1.)

²DBOF is a financing mechanism that DOD established to satisfy its components' recurring requirements using a businesslike buyer-to-seller approach to operations.

Table 1: Value of Secondary Item Inventory, as Reported by DOD (Fiscal Years 1989-92)

Dollars in billions		
Fiscal year	DOD-reported value of total inventory	DOD-reported value of potential reutilization/disposal stock
1989	\$109.4	\$10.1
1990	101.7	8.1
1991	88.1	0.2
1992	80.2	0.3
Overall change	(29.2)	(9.8)

Note: Parentheses indicate a decrease.

The reported amounts, however, are comparable from year to year only after 1991, primarily because, until then, the services and the Defense Logistics Agency (DLA) used different methods for valuing the inventory. In 1991, DOD established a uniform system for valuing inventory and began reporting those values in the fiscal year 1991 Supply System Inventory Report.³ Under this system, the military services and DLA value all inventory at the latest acquisition cost except that items needing repair are reduced by estimated repair costs⁴ and potential reutilization/disposal stock is valued at salvage prices.

Prior to 1991, the services and DLA used different valuation methods. In one case, the reported amounts included figures that DOD subsequently changed. For instance:

- In 1989, the Army and the Air Force valued items in need of repair at the acquisition cost. The two services did not reduce the value of such items by the estimated repair costs. The Navy had been deducting the estimated repair cost from the acquisition value of items needing repair since 1986.
- In 1989 and 1990, DLA valued its inventory at "standard prices," which were based on the acquisition cost plus surcharges for transportation costs and inventory losses.
- In 1989 and 1990, the DOD components did not reduce the value of the potential reutilization/disposal stock to its salvage value. In establishing the uniform valuation system in 1991, DOD set a salvage value of

³We recommended that DOD establish a uniform inventory valuation method in a previous report, *Defense Inventory: Reports Need Comparable and Comprehensive Data* (GAO/NSIAD-91-266, July 17, 1991).

⁴In a prior report, *Financial Audit: Financial Reporting and Internal Controls at the Air Logistics Centers* (GAO/AFMD-91-34, Apr. 5, 1991), we recommended that the Army and the Air Force adjust items needing repair by deducting the estimated repair cost.

2.2 percent of acquisition cost. In 1992, DOD increased the salvage value to 2.3 percent of acquisition cost.

- In 1990, the Navy compared the estimated original acquisition cost and the latest acquisition cost and valued its inventory at the lower of the two amounts. Using this method reduced the Navy's 1990 inventory by \$3 billion below the 1989 amount.
- The Navy adjusted its physical inventory records to agree with its financial inventory records in 1991, resulting in a \$1.4 billion reduction in the value of its inventory.

The Inventory Valuation Method Used Can Change Inventory by Billions of Dollars

The method used to value inventory can significantly affect the amount of year-to-year inventory changes. Depending on the use of the inventory figures, different valuation methods should be used.

We made two adjustments to DOD's inventory figures to demonstrate the effect of different valuation methods. The first adjustment showed that inventory decreased by \$7.6 billion between 1989 and 1992. The second adjustment showed that inventory decreased by \$12.3 billion over the same time period.

Beginning in 1991, DOD adjusted the latest acquisition value of items needing repair and recognized the scrap value of items to be disposed. These changes are appropriate for financial reporting purposes. In this manner, financial report users are provided a picture that more closely reflects the actual value of the inventory.

However, for inventory management purposes, such as tracking inventory trends from year to year, adjustments such as these can be misleading. This is particularly the case when comparing inventory valued at scrap value on a year-to-year basis because the changes in value are very small even though the actual change in the amount of inventory may be large. Also, when valuation methods are changed year-to-year, trends are distorted and present a confusing picture to decision makers. In addition, the increments can be significantly altered by the valuation method chosen, and if different parts of the inventory are valued differently, the changes in some parts can be masked if not looked at separately. Therefore, it is very important for decision makers to understand how the inventory is valued, and if the methods are different for different parts of the inventory, those parts need to be separated for decision-making purposes.

To show a year-to-year comparison of the inventory at acquisition value, we adjusted the reported values of DOD's secondary item inventory to reflect latest acquisition cost. This adjustment showed that the inventory decreased by \$7.6 billion between fiscal years 1989 and 1992, from \$108 billion to \$100.4 billion. During the same period, we estimate that the acquisition value of the potential reutilization/disposal stock increased by \$7 billion. (See table 2.)

Table 2: Acquisition Value of Inventory, as Estimated by GAO (Fiscal Years 1989-92)

Dollars in billions

Fiscal year	Acquisition value of the total inventory	Acquisition value of potential reutilization/disposal stock
1989	\$108.0	\$7.0
1990	106.8	8.0
1991	103.6	9.4
1992	100.4	14.0
Overall change	(7.6)	7.0

Note: Parentheses indicate a decrease.

For our second year-to-year comparison, we adjusted the inventory figures to reflect estimated repair costs for items needing repair and the scrap price of potential reutilization/disposal stock. This adjustment showed that the inventory decreased by \$12.3 billion between fiscal years 1989 and 1992, from \$92.5 billion to \$80.2 billion. During the same period, the potential reutilization/disposal stock valued to scrap prices increased by less than \$200 million. In 1992, DOD's total inventory was reduced by \$20.2 billion because of revaluations; \$13.7 billion of the reduction was in potential reutilization/disposal stocks. (See tables 3 and 4.)

Table 3: Total Inventory Revalued to Reflect Repair Costs and Scrap Values, as Estimated by GAO (Fiscal Years 1989-92)

Dollars in billions

Fiscal year	Inventory at acquisition value	Revaluation	Revalued inventory
1989	\$108.0	\$(15.6)	\$92.5 ^a
1990	106.8	(15.1)	91.7
1991	103.6	(15.4)	88.1
1992	100.4	(20.2)	80.2
Overall change	(7.6)		(12.3)

Note: Parentheses indicate a decrease.

^aThe actual figure is \$92.46 billion and has been rounded to \$92.5 billion.

Table 4: Potential Reutilization/Disposal Stock Revalued to Reflect Scrap Prices, as Estimated by GAO (Fiscal Years 1989-92)

Dollars in billions

Fiscal year	Inventory at acquisition value	Revaluation	Revalued inventory
1989	\$7.0	\$(6.8)	\$0.154
1990	8.0	(7.8)	0.175
1991	9.4	(9.2)	0.207
1992	14.0	(13.7)	0.321
Overall change	7.0		0.168 ^a

Note: Parentheses indicate a decrease.

^aThe actual figure is \$167.5 million and has been rounded to \$168 million.

Informally, DOD officials agreed that the inventory figures reported in the Supply System Inventory Reports are not comparable from year to year without adjusting for accounting changes. These officials also believe that the methodology we used for estimating the value of the secondary item inventory to make it comparable year-to-year was reasonable. They also stated that billions of dollars of inventory have been sent to disposal.

Funding Levels for the Secondary Item Inventory

Funds are appropriated to the military services to purchase secondary inventory items from DBOF and non-DBOF sources. Supply managers are then responsible for obtaining the items from suppliers.

Table 5 shows funding amounts for secondary items for fiscal years 1992 to 1994. The table lists the amounts appropriated for fiscal years 1992 and 1993.⁵ Because final adjusted fiscal year 1994 appropriation figures were not available, we are providing the amount requested by DOD in its fiscal year 1994 budget. According to a DOD Comptroller official, comparable figures are not available for fiscal years 1989 to 1991.

⁵Fiscal year 1992 funding data was provided to the Chairman, Senate Committee on Armed Services, in a joint GAO and DOD letter dated March 25, 1992 (B-222859).

Table 5: Funding Appropriated or Requested for Secondary Item Inventory (Fiscal Years 1992-94)

Accounts	Fiscal year		
	Appropriations		Budget request
	1992	1993	1994
Dollars in millions			
Operation and maintenance			
Supplies, materials, equipment, and other purchases	\$17,263.5	\$18,238.5	\$18,304.9
DBOF fuel	926.7	927.3	997.7
DBOF materials and supplies	3,548.0	3,866.3	4,041.5
Procurement	2,051.8	2,115.6	1,924.8
Personnel	457.9	455.4	471.4
Research and development	365.9	357.2	328.1
Family housing	27.8	29.2	74.7
Military construction	3.6	1.8	1.9
DBOF ^a	2,017.8	16.6	11.6
Total	\$26,663.0	\$26,007.9	\$26,156.6

Note: According to DOD, Congress directed DOD to transfer \$1.5 billion in fiscal year 1992 and \$6 billion in fiscal year 1993 from DBOF and other accounts to the services. This had the effect of reducing the actual amount of appropriations required to \$25.2 billion and \$20 billion, respectively.

^aThe \$2 billion in 1992 is for the procurement and repair of depot-level repairable items that were not charged to customers in fiscal years 1992 and 1993. The 1993 and 1994 amounts are to purchase Air Force war reserve spare parts.

Table 6 shows the DBOF obligational authority for purchasing secondary inventory items and the amount of authority to be used to cover the fund's operating costs.

Table 6: DBOF Obligational Authority for Secondary Inventory Items (Fiscal Years 1992-94)

Cost category	Fiscal year		
	Appropriations		Budget request
	1992	1993	1994
Dollars in billions			
Inventory purchases	\$16.8	\$15.2	\$16.5
Cost of operations	4.0	3.7	3.7
Total	\$20.8	\$18.9	\$20.2

Source: Department of Defense.

Scope and Methodology

To perform our review, we analyzed DOD inventory records obtained for past reviews. We used Supply System Inventory Reports to determine the value of the secondary item inventory as reported by DOD. We took accounting changes and reporting inaccuracies into account to estimate the latest acquisition value of both the total inventory and the potential reutilization/disposal stock and to estimate the effect of changes in inventory valuation methods.

We performed our work between January and February 1994 in accordance with generally accepted government auditing standards. We did not obtain written DOD comments on this report. However, we informally discussed our methodology and results with DOD officials from the Office of the Comptroller and the Office of Material Resource Management Policy and included their comments where appropriate.

Unless you publicly announce this report's contents earlier, we plan no further distribution until 10 days after its issuance. At that time, we will send copies to the Secretaries of Defense, the Army, the Navy, and the Air Force; the Directors of DLA and the Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

Please contact me at (202) 512-8412 if you or your staff have any questions concerning this report. The major contributors to this report were John Klotz, Assistant Director, and Louis Modliszewski, Evaluator.

Sincerely yours,



Donna M. Heivilin
Director, Defense Management
and NASA Issues

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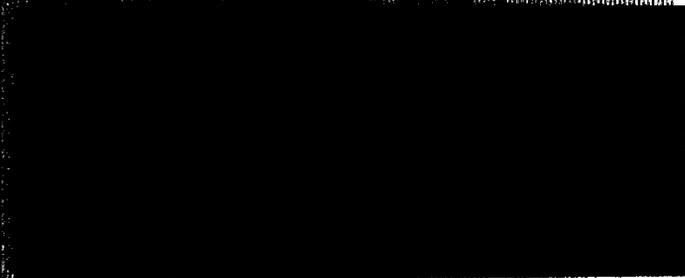
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